Smith, John Benjamin

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AN INQUIRY INTO THE CAUSES OF MONEY PANICS, AND OF THE FREQUENT FLUCTUATIONS IN THE RATE OF DISCOUNT:

A LETTER

ADDRESSED TO

MALCOLM ROSS, ESQ.,

PRESIDENT OF THE MANCHESTER CHAMBER OF COMMERCE.

BY

JOHN BENJAMIN SMITH, ESQ., M.P.

LONDON:
SIMPKIN, MARSHALL, & CO.
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1866.

A LETTER, &c.

Dear Sir,

At the close of the last session of parliament, Mr. Watkin brought forward a motion for "An investigation, by a Royal Commission, into the laws at present affecting Currency and Banking in the United Kingdom." Being desirous of expressing my opinions on this subject, with the concurrence of the Government, I moved the adjournment of the debate to the following day, but Col. Sykes having a motion, which he considered of more importance than Banking questions, he declined to allow the adjourned debate to take the precedence, upon which, members retiring from the House, it was counted out, and there was no other opportunity of resuming the debate on Mr. Watkin's motion.

I was anxious to state my views on this question, because they differed from those of every speaker who took part in the debate, and there seems a fitness in my

addressing this letter to you; first, as affording me the opportunity of expressing more fully the views I intended to offer on the adjourned debate; and second, because the Manchester Chamber of Commerce, in 1840, was the first association to call the attention of the commercial community to the losses sustained by the trade of the country, by the mismanagement of the Bank of England, and I had then the honour to hold the office now held by you.

I was glad, therefore, to see that the Chamber petitioned in favour of Mr. Watkin's motion, because there is no commercial body better entitled to demand inquiry why the evils of which it complained so long ago as 1840 still continue, notwithstanding that the Bank Act of 1844 was expressly passed to prevent their recurrence.

The charges brought by the Manchester Chamber of Commerce against the Bank of England in 1840 were, that notwithstanding the memorandum of the directors, presented to a Committee of the House of Commons in 1832—embodying the principles upon which the Charter was renewed, declaring that the Bank ought to hold a reserve of gold in the proportion of one-third of its liabilities—the directors continually acted in direct violation of their own principle—at one time fostering speculation and over trading by large and injudicious loans, and then suddenly calling them in; thus producing panic, a fall in the prices of all commodities, and serious losses to the commercial community.

As an illustration of its mismanagement, the stock of bullion in the Bank in 1836 was reduced to £4,000,000, while its circulation and deposits amounted to upwards of £30,000,000. To replenish its stock of gold a course of restriction was commenced, which resulted in the panic of 1837, by which the Chamber estimated the loss of capital employed in the production of the five great articles of cotton, woollen, silk, linen, and hardware, amounted to £40,000,000. "This sacrifice," said the Chamber, "of forty millions at the least, and which constitutes a fraction only of the losses simultaneously sustained by the entire commercial world, was incurred in order that the Bank of England might regain possession of six or seven millions of specie, which it had previously forced out of the country by the undue expansion of the currency."

"It has been shown that the Bank no sooner found itself in a safe position than it recommenced, in 1838, a system of expansion, and exported a part of its stock of gold. Prices of the great staples before enumerated, consequently advanced during the year 1838, and part of the year 1839, until, as we have seen, the restrictive policy (its stock of bullion in November, 1839, being reduced to £2,545,000) was resumed, the motion of the screw was reversed, and, down to the present moment, prices have again fallen 20 to 30 per cent., thus inflicting upon the already prostrate trading and manufacturing interest a repetition of the sacrifices of 1837.

"By these forced expansions and contraction of the

currency, during the last three years, some of the most prudent and wealthy of our merchants and manufacturers have incurred that ruin which, in a more wholesome and natural state of the circulating medium, could befall only the reckless adventurer or gambler. Under such a state of things as has been described, calculations based upon the most enlarged experience, afford no security against loss and failure. The trader learns the fate of his undertakings, not in the markets of the world, as influenced by the law of supply and demand, but in the acts of twenty-six irresponsible individuals, conducting a Joint-Stock Banking Association in the city of London."

Such were the complaints by the Chamber of the evils arising from the mismanagement of the Bank of England in 1840, and to remedy which the Bank Act of 1844 was passed. Two and twenty years have since elapsed, and the evils now complained of bear so strong a resemblance to those of 1840, that they appear like a mere recital of the complaints of that period.

The late panic, which has arisen from the same causes as all previous panics, viz.—the imprudent loans and reckless facilities granted to gamblers by money lenders, although it has not affected the commercial and manufacturing community so severely as in times past, has nevertheless, as all panics do, caused embarrassment and loss, even to the most prudent traders, and has aroused an unanimous call for parliamentary inquiry, with a view to some remedy to prevent their recurrence.

In the discussions in parliament, and in the chief publications of the day, the evils complained of, are attributed to the existing Bank Act of 1844, and it has been so much the custom to attribute all money derangements to the monopoly of the Bank of England, that we are too apt to overlook the great changes which have taken place in our money relations since that time.

Previously to 1844, the Bank of England possessed unrestricted power to issue notes, and we have seen the misfortunes which resulted from the unskilful exercise of that power by its directors.

The Act of 1844 introduced important changes. The Bank was divided into two parts, entirely independent of each other. One part was called the Issue Department, which was allowed to issue notes to the extent of £14,000,000 (now £15,000,000) upon government securities; but beyond that amount, no notes could be issued except on the deposit of gold. The object of this restriction was to limit the issue of notes, so as to insure their convertibility into gold; and, inasmuch as the circulation of Bank of England notes in the hands of the public, never falls so low as £15,000,000, but amounts usually to upwards of £20,000,000, that object is effectually secured.

The other division of the Bank, was called the Banking Department, and, as such, it had no further connection with the Issue Department, than any other bank. The Banking Department is simply a bank of

deposit and discount, without any privilege which is not enjoyed by other Joint Stock Banks.

This alteration in the Bank of England greatly limited its power. It could no longer make use of its credit by the issue of notes *ad libitum;* it was confined altogether to trading with its capital and deposits.

In the meantime, a new money power was growing up, and this new power has been ignored in all the discussions on the Banking question.

The Joint Stock Banks of London have, since 1844, by the security which they afford to the public, and the ability, and success of their management, been gradually absorbing the business of the private banks, and have also obtained the greater portion of the new business, arising out of the increasing trade of the country They have, besides, introduced a new principle, which has doubtless added largely to their business, and to their power over the money market. The Bank of England, and the private banks, allow no interest on the sums deposited with them, while the Joint Stock Banks do allow interest on deposits, and have, by this means, accumulated deposits beyond those of the Bank of England.

The result of these important changes is this: that formerly the Bank of England, by its large deposits and its circulation, controlled all other Banks; but now that power has passed away, and it is become a mere passive agent in the hands of the Joint Stock Banks.

The united deposits of only three of the London Joint Stock Banks amount to £60,000,000; the usual

deposits of the Bank of England are about £18,000,000.

Seeing that the Joint Stock Banks have become the controllers of the money market, it is important to inquire, what are the principles on which their business is conducted. For want of weekly returns of their condition, similar to those required of the Bank of France, we are, however, left nearly in the dark. The only light we have, is derived from their meagre half-yearly statements to their shareholders; and these statements show, a wide departure from the practice of the Bank of England.

The principle laid down by the Bank of England is, that its reserve of cash on hand, ought to be equal to one-third of its liabilities; and it is only just to the directors of that Institution to say, that of late years, so far as they have been free agents, they have endeavoured to conform to this wise principle.

The practice of most other Banks in London is, however, to keep as little reserve in cash as possible. They regard neither the principle laid down by the Bank of England, nor the peculiar responsibility of Banks whose ramifications are spread, and whose operations are felt, not only throughout the British Empire, but all over the world.

London, is the great centre where all the money transactions of the British empire, and a large portion of those founded on the trade of foreign countries, are balanced. Bankers all over the kingdom have agents in London. Traders everywhere make their acceptances

payable in London. Purchases of foreign produce, in all parts of the world, are paid for by drafts on London, or payable in London; and a large portion of the trade of foreign countries, is transacted by credits on London. On the other hand, in addition to the funds required to make provision for this enormous mass of engagements, the spare floating capital of the country finds its way to London to seek employment.

According to the statements made to their shareholders, to the 30th June, 1866, by three of the Joint Stock Banks of London, which may be taken as an illustration of the practice of all, their aggregate deposits amounted to £60,487,565.

If the business of these Banks, were conducted on the same principle as that of the Bank of England, with this amount of deposits, they ought to have held a reserve of cash on hand of £20,000,000; but, according to their statements, their aggregate reserve of cash was reported to be only £7,470,000.

It is important to observe, however, that this reserve of £7,470,000 did not consist, like the reserves held by the Bank of England, of cash on hand in the Bank. What these Joint Stock Banks call "cash on hand," was composed partly of cash on hand in their Banks, partly of deposits in the Bank of England, and partly of money lent on call. There being no details given of the proportions of cash, we are left to conjecture; but probably not more than £4,000,000 of the reserve, consisted of cash on hand in their Banks.

Besides the reserve of £7,470,000 held by these banks, they report that they also held a reserve of £4,977,539 in Consols and other Government securities; but, as the Bank of England only considers that to be a reserve, which will pay the demands upon it for deposits—viz., cash—and as Consols, and India Bonds, will not pay cheques, these securities are no more a reserve than Bills of Exchange, or any other negotiable security, and cannot, therefore, be accounted a legitimate reserve.

Can any system be more unsound, or dangerous, than that pursued by these Joint Stock Banks? With deposits amounting to £60,000,000, they ought, adopting the principles of the Bank of England, to have held a reserve of cash in their Banks of £20,000,000, whereas they only held about £4,000,000.* So long as their daily receipts, amount to about the same sum as their daily payments, all goes on smoothly; but as soon as they are called upon for payments, beyond their receipts, what is the consequence? Every step they take to meet these demands, creates a disturbance in the money market.

Supposing a demand upon these Joint Stock Banks to arise, for two millions of their deposits. If they held a reserve of cash on hand of £20,000,000, the call for such a sum would be scarcely felt, and would produce no effect whatever on the money market; but with a reserve

* In cases where Banks make deposits in the Bank of England, if they be called a reserve of cash on hand, the amount so deposited, ought to be deducted from such reserve, or from the reserve of the Bank of England, otherwise the aggregate reserves, are by so much reckoned twice over.

of only £4,000,000, it would become necessary to make immediate provision to meet it.

As a means of meeting it, they must either draw on their reserves in the Bank of England, demand their money lent on call, or diminish their usual investments in discounts.

If the £2,000,000 were drawn from their deposits at the Bank of England (supposing the deposits of the Bank of England at the time to be £18,000,000, which is about the amount of their usual deposits, and its reserve to be one-third of its deposits, or £6,000,000), its deposits would be thereby reduced to £16,000,000, and its reserve to £4,000,000.

But supposing these Joint Stock Banks, instead of withdrawing the two millions from the Bank of England, were to raise it by demanding their money lent on call, and by the stoppage of their usual discounts, the disturbing effects produced upon the money market would be exactly the same.

The payers of the money on call, and the holders of bills refused discount, would have to provide themselves with money elsewhere; but attempts to open new channels, when old ones are suddenly closed, creates alarm, and the holders of money, looking to their own probable requirements, are indisposed to part with it; the only recourse, therefore, is the Bank of England, which, being the only Bank which keeps an adequate reserve, is the only resource in times of pressure.

But the Bank of England is now, only one of many

Joint Stock Banks, and no longer able to control the money market; and though it may keep a reserve in cash adequate to meet its own obligations, this reserve is insufficient to meet the obligations of all other Banks. When, therefore, the over-trading Banks are unable to meet the calls upon them for cash, and a drain sets in on the reserve of the Bank of England, it has only one means to defend its treasure, viz., to become the innocent instrument of the over-trading Joint Stock Banks, to raise the rate of interest.

Let us, however, carry our supposition a little further. Supposing the drain upon the deposits of these Joint Stock Banks continued, until it amounted to £4,000,000. With a reserve of £20,000,000, there would still be no cause for alarm; or any necessity to disturb their regular course of business; but, having no reserve, this additional demand for two millions would, like the former, find its way to the Bank of England; and, while the deposits of that Bank would then be reduced to £14,000,000, its reserve would be reduced to £2,000,000.

A reduction of its reserve to £2,000,000 would create a panic; the innocent victims of this panic, the public, would, as usual, discharge their vials of wrath upon the Bank of England, while the real delinquents, would be reaping a rich harvest, by the increased gains of a high rate of interest on their enormous deposits.*

* The profits realised for the half-year ending June 30, 1866, by the three London Joint Stock Banks referred to, were at the rate of 25, 29, and 50 per cent per annum on their respective capitals.

That there should be so striking a similarity, between the complaints of the Chamber in 1840, and those of the public at the present day, is not surprising; for, in fact, the trading community, are labouring under the same disease now, which was pointed out by the Chamber then.

This disease, is caused by the over trading of the Banks, which hold the floating capital with which the business of the country is carried on.

As the Chamber pointed out in 1840, the Bank of England, then the controller of the money market, while laying it down as a principle, that one-third of its liabilities ought to be held as a reserve in cash, in 1836, with liabilities amounting to upwards of thirty millions, reduced its reserve to four millions; and again, in 1838, reduced its reserve to only two and a half millions. This trading with the reserve, which it ought to have held in the Bank, produced the panics and calamities to which we have referred.

Since then, the Joint Stock Banks have become the controllers of the money market, and they are now following the same course which the Bank of England pursued.

The public furnish the deposits, by the employment of which, these Banks are enabled to make their enormous dividends; but instead of being allowed to participate in the advantages, of a portion of the capital, which they themselves furnish, being set aside to form adequate reserves to provide against fluctuation, these

Banks appear, not to have deemed it necessary to lay down any other principle, than that of making the largest dividends they can for their shareholders. Like the Bank of England in times past, they are trading on the reserves of cash, which ought to be in their coffers; and the results to the public are alike calamitous, and are exhibited, as they always must be, in constant little panics, and by no less than eighty-five changes in the rate of discount, from 1858 to 1865.

A state of things like this, cannot fail to give rise to grave reflections. The constant fluctuations in our money market are felt, more or less, all over the world, and as no foresight can guard against them, our foreign trade is become a species of gambling—success depending upon the accident, of the rate of discount when produce arrives at market.

Look at the extraordinary position, in which our trading community is placed. With reserves of cash on hand, at the great centre where all the money engagements of the empire are balanced, little beyond those of five-and-twenty years ago, our foreign trade since that time has trebled—our imports and exports in 1865 amounting to £435,000,000. Our internal trade has increased in like proportion, and both together probably amount to more than £1,000,000,000. The floating capital of the country has kept pace with the increase of trade; nevertheless, such is our system of banking, that the base on which this vast superstructure of trade rests, consists chiefly of the six to eight

millions of reserve in cash, usually held by the Bank of England!

Is it surprising, that we hear constant complaints of little panics, and frequent fluctuations in the rate of discount? Is it not rather to be wondered that great panics are not more frequent?

It is vain to rail against Peel's Bill, and to hold up its repeal as the remedy for these evils. What does the repeal of the Bank Act of 1844 mean? Simply this: to give the Bank of England, the power of trading, with the reserve of gold, held in the Issue Department, as a security for the convertibility of its notes—a course which would again subject us, to all the perils which the Chamber pointed out in 1840, without curing the evils of which we now complain.

What we need, is a broader basis, on which to rest our vast trade and commerce; a fund to fall back upon, to provide against those temporary fluctuations in trade, and in the supply and demand for money, which, as men of business, we know are incident to trade, without prostrating our industry, and throwing the whole country into convulsions, by the export of a few millions of gold.

These are the great objects which claim our attention, and our inquiries should be directed to the means of effecting them.

Is the time arrived, when Bank monopolies, should share the fate of all other monopolies?

Is it desirable, with the view to place our currency on the soundest footing, that the same power which

coins money, should alone issue bank notes?* A course which, while it would remove all distrust of the currency, would at the same time enable the State to contribute, at least half a million annually, to the reduction of the national debt.

What measures are necessary, to enforce a management of Joint Stock Banks, less injurious to the public than the present?

Would the abolition of the monopoly of the Bank of England, teach other Joint Stock Banks to rely on their own reserves, instead of the reserve of other Banks?

It may also be worthy of consideration, how far the principles adopted by our brethren across the Atlantic, may meet our own wants.

The United States, after experimenting in all sorts of currency nostrums, acknowledge them to be failures, and have at length arrived at the conclusion, that there can be no sound banking without adequate reserves; and that the principle propounded by the Bank of England, more than thirty years ago, but which it never put in practice, until it became powerless to control the money market, is more consistent with common sense, than the fine-spun theories of currency quacks, or those mystical lucubrations, which have so puzzled men's brains, as to drive many to the conclusion, that currency, is the only question which is incomprehensible.

* It is said that during the late panic about a million was abstracted from the money market by issuers of notes, to provide against possible public distrust of their issues.

The recent law, permitting the establishment of National Banks in the United States, specially provides, that every bank in a large town "shall, at all times, have on hand, in cash, an amount equal to at least 25 per cent, of the aggregate amount of its notes in circulation, and its deposits, and whenever the cash of any Association, shall be below 25 per cent of its liabilities, such Association, shall not increase its liabilities, by making any new loans or discounts, nor make any dividends of its profits, until the required proportion between the aggregate amount of its liabilities, and its cash, shall be restored."

It will be no less instructive, to compare the condition of the Bank of France, and of the Banks in the leading cities of the United States, with those of London at the same period, viz.:—

1866.		Liabilities.	Cash on Hand		Per Centage of Liabilities.
July	5—Bank of France	£60,704,600	£26,729,500	=	44
June	30—Banks of New York...	£46,200,000	£17,920,000	=	39
July	2—*Banks of Boston ...	13,400,000	4,850,000	=	36
,,	2—Banks of Philadelphia	9,313,000	4,460,000	=	48
		£68,913,000	£27,230,000	=	40
July	5—Bank of England......	£27,425,617	£4,065,080	=	15
June	30—Three Joint Stock Banks of London...	60,487,565	4,000,000	=	7
		£87,913,182	£8,065,080	=	9

* These American Banks, have adopted the London practice of checks, and clearing houses.

It results, from the above comparison of the condition of the Banks of France, the United States, and of London, that if the Bank of England, and the three Joint Stock Banks of London, holding on the 30th June, 1866, aggregate deposits amounting to eighty-eight millions, had held at that time, reserves of cash commensurate with the reserve held by the Bank of France, their aggregate reserves would have amounted to thirty-eight millions. If their aggregate reserves, had been equal to those of the Banks of New York, Boston, and Philadelphia, they would have amounted to thirty-five millions. But their aggregate reserves, at that time, amounted to only eight millions!!

Such an exhibition of facts requires no comment, but it presents an unanswerable argument, for a complete, and searching inquiry, into a subject so deeply affecting the interests, of every class of traders in the empire.

Truly yours,

J. B. SMITH.

King's Ride, Ascot, Berks,
October 10, 1866.

To MALCOLM ROSS, Esq.,
President of the Chamber of Commerce at Manchester.

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